No. 96-1580

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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,
Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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REVIEW BY THE UNITED STATES SUPREME COURT IS NOT WARRANTED

United States Supreme Court Rule 10 admonishes potential petitioners that a Writ of Certiorari will be granted only for *compelling* reasons. No compelling reasons exist in the instant case. There are no constitutional issues presented, no conflicts with the decisions of a state court of last resort, the circuits, or this court.

The Ninth Circuit Court of Appeal applied hundreds of years of trust law, the mandates of ERISA, and its decision is in conformance with all circuits that have analyzed issues of fiduciary duty with respect to Employee Stock Ownership Plans ("ESOPs"). While deciding an issue of major import to the litigants, the Ninth Circuit has not decided a federal question in a way that either conflicts with relevant decisions of this court, or is unique. There is no departure from accepted and usual judicial proceedings whatsoever.

The "Questions Presented" by the petitioners have been answered uniformly amongst the circuits, and the Ninth Circuit Court of Appeal in reversing the United States District Court's decision. Pursuant to Rule 15.2, respondents object to petitioners' brief to the extent that it challenges or seeks to correct *valuation* issues, which are not ripe for decision, and have not yet been decided on remand by the district court.

With respect to California Corporations Code § 1800, the application of state corporate securities law is specifically sanctioned by ERISA, the Internal Revenue, and the Department of Labor, and is consistent with all circuit courts that have analyzed this valuation process, and valuation issues in stock transfers generally.

The petitioners assert that a conflicted fiduciary can blindly rely on a retained valuation expert without questioning or investigating the assumptions or the conclusion. Such conduct is not authorized by ERISA, not supported in case law interpreting fiduciary duties, and certainly not raised to the status of a conflict. The circuit courts are in accord that a fiduciary must conduct an independent investigation of the transaction. Further, ERISA contemplates fiduciaries not predetermining the results. Conduct such as displayed by the fiduciaries in the instant case would not be condoned under any circuit court rationale.

There are no special or important reasons for the United States Supreme Court to review the conduct of conflicted corporate officers/ERISA fiduciaries who decided *in advance* to accept a predetermined appraisal, concocted and molded to fit the desires of a controlling shareholder and fellow fiduciary, who also happened to be the President of the Company, and indirect purchaser of the stock. This is certainly true in light of the uncontroverted fact that the controlling shareholder (Edward A. Shay) was seeking at the outset of the ESOP termination to "pay as little as he could get away with", and to regain 100% control of his company as an estate planning device, for the benefit of his heirs, including his son, Allen Shay, now president of Pacific Architects & Engineers. (RT: XII:64:12-19)

The standard of review was correct. The Ninth Circuit Court of Appeals' decision was correct. There is no issue to be decided by the United States Supreme Court.

STATEMENT OF THE CASE

Petitioner, Pacific Architects and Engineers, Incorporated ("PAE") is a California corporation that is

primarily a real estate holding company, owning domestic and foreign property, as well as being engaged in engineering and architectural operations worldwide (A 3). In 1974, the 100% shareholder, Edward A. Shay ("Shay") authorized the creation of an ESOP, and sold 40% of PAE stock to the ESOP at $10.67 a share (based on PAE's appraised value of $10,670,000. (A 3). In 1988, Shay instructed that the ESOP be terminated, and that family trusts controlled by him purchase the employee's 40% block of stock "for as little as he could get away with". The district court record reveals that the purpose of the termination of the ESOP was part of Shay's estate planning for his son, co-defendant, Allen Shay (Ex. 31; 47, 50; RT: IV:58:8-59:17).

At all times during the pendency of the ESOP, defendants/respondents Shay, Lehrer and Smith were senior executives of PAE and the entirety of the Board of Directors. They were the three fiduciaries of the ESOP at the time of termination in 1988. (A 3). Both Lehrer and Smith had worked directly for Shay for many years, and admitted repeatedly that Shay had absolute control over PAE, and all of the employees of this privately held corporation. (RT I:141:23-142:1, RT: IV:83:13)

In 1988, after shopping around unsuccessfully for other appraisers, Smith hired Arthur Young ("AY") to value the stock on the conditions that the valuator would agree in advance to limit its investigation, accept the characterization of the corporation as given by the conflicted fiduciaries, and not contact the joint venturer of PAE, Jardine Mathison (which owned 50% of K.K. Halifax, the largest asset of PAE) (A 4). In July 1988, months before the final evaluation was printed, PAE informed AY that Shay would be purchasing the ESOP's stock (A 4).

Prior to the valuation or appraisal by AY, the fiduciaries agreed in advance, without even seeing the appraisal, to accept AY's valuation as the sale price of the stock to Shay or his nominee (A 4). The fiduciaries did not review, discuss or question the valuation (A 11), and voted to sell the stock to the nominee of Shay (his heirs) for $14.40 a share, a mere 17¢ on the appraised dollar value of $83.42 per share (A 6). The nominee was a trust concurrently created for the benefit of Allen Shay, to allow the aging and infirm Shay to reacquire 100% of the company that he controlled and had founded. (Shay died in 1995.) The vote agreeing to $14.40 a share represented a compound growth rate of the stock of 2.2% from 1974 through 1988 (A 3). This rate was deemed appropriate by the conflicted fiduciaries even with full knowledge that the real estate holding assets of PAE included properties in Tokyo and Los Angeles which had been appraised for over $78 million dollars, an eight fold increase during the life of the ESOP. (Ex. 17: 17174-79)

PAE supplied information to AY, which relied completely on the information, without investigation. AY's qualifications to its evaluations stated clearly that:

> We have relied upon the assertion of management and other third parties that the financial data and real estate appraisal reports described in this report provide a reasonable representation of fair market value and historical operation of the company and the condition of [PAE's] real estate investments. (A 4-A 5).

AY further relied on PAE's attorney (the same law firm representing PAE in the instant litigation) that California Corporations Code § 1800 did not give the ESOP any rights to trigger an involuntary dissolution. The district court

record reveals that PAE's attorney denied giving any legal opinions as to the impact of § 1800, but rather referred to her conclusions as an "explication". The record is devoid of any case law, legal reasoning or legislative history that supported the "explications" of PAE's corporate attorney in interpreting § 1800.

Fiduciary Smith signed an Officer's Certificate stating the ESOP had no remedies under § 1800 (Ex. 17:17239) but admitted total ignorance as to the basis or accuracy of his conclusion. The regular counsel to the ESOP was never even consulted on this issue. (RT: II:128:19-129:22; V:57:4-8).

The Ninth Circuit offered a different perspective on § 1800, one that most assuredly should have occurred to the conflicted fiduciaries:

> We agree with plaintiffs that the *district court erred in finding that ERISA preempts Cal. Corp. Code § 1800.* 29 U.S.C. § 1144; *see Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498, 1504 (9th Cir. 1993). It seems, however, that *even if ERISA did preempt Cal. Corp. Code § 1800, the statute would nevertheless deflate Pacific's minority interest discount, since a third-party buyer would be entitled to its possible benefit.* (Emphasis added.) (A 10)

Based on the representations of the conflicted fiduciaries, AY valued PAE at $83.42 per share. It then applied various discounts and arrived at the purported fair market value of the stock to be sold by the ESOP to Shay of $14.40 a share. The district court and the Ninth Circuit both found that the fiduciaries had a conflict of interest and thus had the burden of establishing that the sale price was for "adequate consideration" and fair market value (A 8,

E 5). The district court erroneously applied the "business judgment rule," a creation of corporate law, having nothing whatsoever to do with fiduciary duties or ERISA. By applying a completely incorrect legal standard, the district court found no breach of duty (D 9, No. 8).

On appeal, the United States Department of Labor filed an amicus curiae brief in support of the position of respondents as did the American Association of Retired Persons (AARP) (separately and concurrently lodged with respondent's opposition). The Ninth Circuit was not only in possession of the entire record of the district court, but the opinions of the Department of Labor, and a group of affected and interested persons represented by the AARP. Both briefs asserted that the transaction was tainted, not for adequate consideration, and that the "business judgment rule" would not only be erroneous, but have tragic and improper consequences for millions of workers whose pension plans could be undermined by business vagaries as opposed to protected by trust principles. The AARP observed that the district court opinion threatened the retirement security of 11.3 million employees. (Citing M. A. Conte & H. H. Lawrence, "Trends in ESOPs", in *Trends in Pensions 1992*, U.S. Department of Labor, Pension & Welfare Benefits Administration.)

On November 22, 1996, the Ninth Circuit Court of Appeal reversed the district court's decision of October 1, 1993. A Petition for Rehearing En Banc was filed by the Shay defendants, but no Ninth Circuit judge voted to hear the matter en banc (C 2). The Ninth Circuit decided *only* the question of fiduciary duty. No opinion was rendered as to the true and proper fair market value of the ESOP block of stock. This matter was properly remanded to the district court, which action has now been stayed pending this Petition for Writ of Certiorari.

With respect to the outcome presently before this court, the Ninth Circuit found:

> . . . that even if the district court applied the prudent man standard, it did not apply it correctly. The fiduciaries failed to carry their burden of proving that they fulfilled their duties of care and loyalty and that the ESOP received adequate consideration. (A 9).
>
> . . . Even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of this tack. (A 9-A 10).

Citing directly from the seminal case of *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251, 104 S.Ct. 3533 (1984) the Ninth Circuit correctly concluded that "[a]n independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to insure their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly." (A 11)

The present status of the case is that the correct fiduciary standard ("the highest known to the law") was applied by the Ninth Circuit, which conforms with all other circuits, and conclusively demonstrates the breach of duty by the conflicted fiduciaries.

THE PROPER STANDARD TO MEASURE A FIDUCIARY'S CONDUCT IS SET FORTH IN ERISA AND WELL ESTABLISHED TRUST LAW

Congress adopted ERISA's fiduciary rules from the common law of trust with the instructions that these rules are to be interpreted "bearing in mind the special nature and purpose of employee benefit plans." (H.R. Rep. No. 93-

1280, 93rd Cong. 2d Sess., Reprinted in 1974 U.S. Code Cong. & Ad. News at 5083.) In accord with this legislative history are the Supreme Court cases of *Firestone Tire & Rubber Company v. Bruch*, 489 U.S. 101, 110-11, 109 S.Ct. 948, 954 (1989) [in determining the proper standard of court review for benefit denials, "we are guided by principles of trust law"] and *Central States v. Central Transport, Inc.*, 472 U.S. 559, 570, 105 S.Ct. 2833, 2840 (1985) ["[R]ather than explicitly enumerating *all* of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility."]. *Howe v. Varity Corporation*, 36 F.3d 746 (8th Cir. 1994) *cert. granted, affirmed, Varity v. Howe* ___ U.S. ___, 115 S.Ct. 1793 (1995) agrees with Justice Brennan's concurring opinion in *Massachusetts Mutual Life Ins. Co. v. Russell*, 473 U.S. 134, 105 S.Ct. 3085 (1985) in which Justice Brennan found that ERISA was intended to incorporate the law of trusts.

Even before the United States Supreme Court decisions, the Ninth Circuit found: "[c]ourts have also recognized that in enacting ERISA, Congress made more exacting the requirements of the common law of trusts relating to employee benefit trust funds". *Donovan v. Mazzola*, 716 F.2d 1226, 1231 (9th Cir. 1983), *cert. denied* 464 U.S. 1040, 104 S.Ct. 704 (1984) citing *Sinai Hospital of Baltimore v. National Benefit Fund for Hospital &*

Health Care Employees, 697 F.2d 562, 565 (4th Cir. 1982).[1]

In deciding in favor of the defendant fiduciaries, the district court stated that it was utilizing the "business judgment rule". (A 7, A 9, D 9 No. 8, E 27) The "business judgment rule" reflects an inquiry into the subjective "good faith" of the officers of the corporation, and "exist(s) to protect and promote the full and free exercise of the power of management given to the directors." Fletcher Cyc. Corp. § 1039 (Perm. Ed.) Under the "business judgment rule" the officers and directors are generally not liable for "mere mistakes or errors of judgment, either of law or fact." Id. This is true even where the errors may be so gross "that they demonstrate the unfitness of the directors to manage the corporate affairs." *Id.*

The test imposed by ERISA's prudent person rule does not focus on the fiduciaries' subjective good faith but

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[1] The lower court's decision is at odds with the following pertinent circuit authority. *See Donovan v. Cunningham*, 716 F.2d 1455, 1464 n.15 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251, 104 S.Ct. 3533 (1984) ["ERISA's modifications of existing trust law include imposition of duties upon a broader class of fiduciaries, prohibition of exculpatory clauses, broad disclosure and reporting requirements, and nationwide uniformity of rules." (Citations omitted.)]; *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488 (1982) [the fiduciary obligations of ERISA are the "highest known to the law."] Accord, *Biggers v. Wittek Industries, Inc.*, 4 F.3d 291, 295 (4th Cir. 1993); *Warren v. Society National Bank*, 905 F.2d 975, 979-81 (6th Cir. 1990); *Leigh v. Engle*, 727 F.2d 113, 122-23 (7th Cir. 1984); *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Fink v. National Savings and Trust Co.*, 772 F.2d 951, 955 (D.C. Cir. 1985). See, also *Deibler v. United Food and Commercial Workers' Local Union* 23, 973 F.2d 206, 210 (3d Cir. 1992) [relying on trust law principles].

plainly relies on external, objective standards of conduct which incorporate a process by which a fiduciary actually evaluates an investment. Unlike the business judgment rule, under ERISA's prudent standard a fiduciary may not simply rely on the advice of others. As the court noted in *Whitfield v. Cohen* 682 F.Supp. 188 (S.D.N.Y. 1988):

> While a trustee has a duty to seek independent advice where he lacks the requisite, education, experience, and skill, (citations omitted) the trustee, nevertheless, must make his own decision based on that advice. *Whitfield* 682 F.Supp. at 194

The trustee's obligation is aptly summarized in *Litchfield v. White* 7 N.Y. 438 (1852):

> The diligence of a provident man therefore is the measure of a trustee's duty. If it were otherwise, there would be one rule for a careless, and a different rule for a vigilant trustee; and a careless trustee would be exonerated in the same case in which the vigilant would be held liable. This was never intended, either by the elementary writers or by the authorities from which they deduce these conclusions. *Litchfield* 7 N.Y. at 443-44

29 U.S.C. § 1104 (ERISA § 404) and 29 U.S.C. § 1106 (ERISA § 406) prohibit transactions when there is a conflict of interest. While there are exceptions provided in 29 U.S.C. § 1108 (ERISA § 408), they are not applicable here. There can be no clearer conflict than when the purchaser controls the livelihood of the fiduciaries who agree to sell the stock for as little as they can get away with. "In short, the fiduciary provisions of ERISA were designed to prevent a trustee 'from being put into a position

where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries.' H.R. Conf. Rep. No. 93-1280, *supra*, at 309, U.S. Code Cong. & Admin. News 1974 p.5089" *N.L.R.B. v. AMAX Coal Company*, 453 U.S. 322, 334, 101 S.Ct. 2789, 2796, (1981).

> This rule [ERISA § 406] both assures protection to plan beneficiaries and provides notice to plan fiduciaries of their obligations. It protects beneficiaries by prohibiting transactions tainted by a conflict of interest and thus highly susceptible to self-dealing. It gives notice to fiduciaries that they must either avoid the transactions described in Section 406(b) *or cease serving in their capacity as fiduciaries, no matter how sincerely they may believe that such transactions will benefit the plan.* Such protection of beneficiaries and notice to fiduciaries requires that Section 406(b) be broadly construed (citation omitted) and that liability be imposed even where there is "no taint of scandal, no hint of self-dealing, no trace of bad faith." *Cutaiar v. Marshall*, 590 F.2d 523, 528 (3d Cir. 1979), . . . *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1213 (2nd Cir. 1987). (Emphasis added.)

In this case it is impossible to assert there is "no taint of scandal, no hint of self-dealing, no trace of bad faith" when the ESOP's only asset was sold for $.17 on the appraised value dollar to the controlling shareholder of the corporation who held in his hands the economic well-being of the fiduciaries who voted to sell him the stock.

> Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, *after careful and impartial investigation*, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries. (Citation omitted.) *This, in turn, imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan. Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982). (Emphasis added.) See also, *Burud v. Acme Electric Company, Inc.*, 591 F.Supp. 238, 247 (D.Ala. 1984).

The duty of undivided and complete loyalty to the plan participants and beneficiaries requires fiduciaries ". . . to step aside in favor of a neutral referee, or at the least, to conduct an explicit inquiry into the potential for a conflict of interest." *McMahon v. McDowell*, 794 F.2d 100, 110 (3rd Cir. 1986).

> As a practical matter, we view favorably the suggestion of the Secretary of Labor, as *amicus curiae*, that the preferred course of action for a fiduciary of a plan holding or acquiring stock of a target, who is also an officer, director or employee of a party-in-

> interest seeking to acquire or retain control, is to resign and clear the way for the appointment of a genuinely neutral trustee to manage the assets involved in the control contest. Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. *Leigh v. Engle*, 727 F.2d 113, 132 (7th Cir. 1984).[2]

The decision that Shay would remain a fiduciary was a corporate decision. Lehrer admitted that he did not even have the capacity to determine if he had a conflict of interest. (RT:II:162:20) Smith never even considered the issue. (RT:IV:128:14-24; 176:23-177:1, V:30:9-21)

It is undisputed that defendants decided that an independent fiduciary was not necessary. The only stated reason for such a decision was that it would cost between $50,000 and $100,000 to have an independent fiduciary, i.e., 1% to 2% of the heavily discounted price paid for the stock by the Shay defendants. Obviously, this was a small

---

[2] In sharp contrast to this unequivocal standard is the *Howard* trial court's finding that: "Where a controversial choice by an employer-fiduciary would advance the employer's interest, a literal application of the exclusive benefit rule does appear to mandate resignation of the fiduciary. Sometimes this is appropriate. See, *Schwartz v. Interfaith Medical Center*, 715 F.Supp. 1190 (E.D.N.Y. 1989). But courts understandably conclude that such an extreme requirement often constitutes overkill and is not always appropriate. Any workable rule must take into account the nature of decision making and the virtual inevitability of complex motives. The first step is to decide when fiduciary action on mixed motives (whether or not by an employer-fiduciary) should be treated as wrong. On that basis pragmatic standards may be developed for identifying violations." (E 22) Judge Dickran Tevrizian was wrong, causing reversible error.

price to pay to assure the retirement benefits of over 800 people placing no burden on a company valued at $83,000,000.

ALL CIRCUITS AGREE THAT THE TRUST LAW MODEL IS THE PROPER MEASURE OF FIDUCIARY DUTY

The petitioners attempt to artificially create a conflict to satisfy U.S.S.C. Rule 10, citing *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984) and *Eyler v. C.I.R.*, 88 F.3d 445 (7th Cir. 1996). They argue that the mechanical steps taken by the fiduciaries of securing an appraisal somehow shields them from liability. They boldly assert that the only fiduciary requirements to which they should be held are that they provide appropriate information to a valuator and accept that valuator's result without an independent investigation. Such a mechanical approach has never been sanctioned by any court and should not even be considered for review by this court. No reasonable fiduciary looking to the beneficiaries protection could ever assert such a grotesque distortion of ERISA's legislative intent.

Indeed, this court in *Firestone Tire & Rubber Company v. Bruch*, 489 U.S. 101, 109 S.Ct. 948 (1989) confirmed that ERISA was created for the benefit of plan participants and beneficiaries in order to regulate, not benefit or protect, fiduciaries (*Firestone*, 489 U.S. at 113-114, 109 S.Ct. at 956; *Kim v. Fujikawa*, 871 F.2d 1427, 1433 (9th Cir. 1989)). Further, as stated in *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134, 105 S.Ct. 3085 (1985):

> . . . [C]ourts must always bear in mind the ultimate consideration whether allowance or

> disallowance of particular relief would best effectuate the underlying purposes of ERISA - *enforcement of strict fiduciary standards* of care in the administration of all aspects of pension plans and promotion of the best interests of participants and beneficiaries. *Russell*, 473 U.S. at 158, 105 S. Ct. at 3098. (Brennan J. concurring.) (Emphasis added.)

Both the district court and the Ninth Circuit found that the fiduciaries *determined in advance* to accept the findings of AY, concluded in advance to sell the stock at the price set by AY without question, and sold the stock to one of their own based on the AY valuation. This was done without any inquiry as to the correctness of the methodology or even the result to be announced by AY. The entire transaction, and all participants to it, do not meet the letter of ERISA, nor the interpretation of its goals as articulated by this court.

Donovan v. Cunningham, supra, is absolutely consistent with ERISA fiduciary opinions in all of the circuits, and the United States Supreme Court. Although repeatedly cited as evidence of a conflict, that rhetoric is illusionary. At page 1474, the *Donovan* court found:

> *An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled.* It is a tool and, like all tools, is useful only if used properly. *Donovan* 716 F.2d at 1474

> When a fiduciary has dual loyalties, . . . *the prudent person standard requires that he make a careful and impartial investigation of all investment decisions.* (Citation omitted.)

> Although Schaefer is not charged with making an improper investment decision, "[a] review of a fiduciary's independent investigation is one of the well-established yardsticks against which courts have customarily tested fiduciary conduct for prudence." See *Donovan v. Bierwirth*, 538 F.Supp. 463, 470 (E.D.N.Y. 1981), modified 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982). *Schaefer v. Arkansas Medical Society*, 853 F.2d 1487, 1492 (8th Cir. 1988). (Emphasis added.)

The holding of *Cunningham* and the cases upon which it relies make it clear that a fiduciary must make an independent investigation and analysis of a proposed transaction in order to properly protect his charges and carry out his solemn duty. What the petitioners seek *is* a magic wand blessing a fatally flawed transaction which endorses their breach of duty of independent investigation and decision.

Eyler v. C.I.R., 88 F.3d 445 (7th Cir. 1996) is even more instructive and is in complete harmony with the Ninth Circuit's decision. The Commissioner of the Internal Revenue sought to impose an excise tax on an ESOP transaction in which the majority shareholders engaged in a prohibited transaction. In determining what was adequate consideration, the fiduciaries relied on a valuation done by Pru-Bache in conjunction with a failed proposed IPO, and relied on experts to argue the adequacy of the consideration. The tax court rejected both arguments, finding that the fiduciary did not meet his burden of establishing that the $14.50 per share price was fair market value of the stock. In the absence of the ESOP receiving adequate

consideration, the sale was a prohibited transaction. On appeal, the circuit court found that the Board members knew that many of the assumptions underlying the Pru-Bache price range were erroneous, and did nothing further to investigate the suggested price. Their actions did not rise to the level of prudence imposed on ERISA fiduciaries:

> In sum, the law requires a fiduciary of an ESOP to act with the care, skill, and diligence that a prudent person would undertake in acting on behalf of ESOP beneficiaries. The degree to which a fiduciary makes an independent inquiry is critical. We find no merit to Eyler's contention that the board of directors was well-informed and, therefore, made a good faith determination of the fair market value of the stock. The record does not show that even one director, let alone a majority, sought independent information on the fair market value of the stock. Rather, on the same day the project was presented, the board voted to guarantee a $10 million loan, the proceeds of which would be used to buy the majority shareholder's stock. *Eyler*, 88 F.3d at 456

Eyler and *Howard* present analogous facts, with both circuit courts condemning the conduct of the fiduciaries.

The petitioners also suggest that there is a conflict between the circuits regarding when a fiduciary may rely on experts. This position is asserted without benefit of any case authority.

In *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied* 104 S.Ct. 704 (1984), the court rejected a defense based reliance on advice of counsel as follows:

> Even if such advice had been received, reliance on counsel's advice, without more, cannot be a complete defense to an imprudence charge. (Citation omitted.) 716 F.2d at 1234.

In *Bidwell v. Garvey*, 743 F.Supp. 393 (D.Md. 1990) the court determined that the management fiduciaries reliance upon counsel for management did not constitute independent investigation or advice sufficient to justify the fiduciaries reliance. *Eyler v. C.I.R.*, *supra*, rejected the reliance upon advice of "experts" and reaffirmed decisions holding that seeking the advice of experts, without further investigation, violated ERISA's fiduciary standards.[3]

Note the circular nature of the petitioners' reasoning. AY expressly relied upon PAE, which relied upon AY, which relied on PAE!

The amicus brief of the governmental agency charged with enforcement of ERISA was sharply critical of petitioners' view on appeal and sets forth the opinion of the Department of Labor. The opinion is authoritative and persuasive in determining the Agency's interpretation of the law and regulations. In *Bartling v. Fruehauf Corp.* 29 F.3d 1062 (6th Cir. 1994), the court observed:

> [W]e are obliged to accord great deference to DOL interpretations. *Blessitt v. Retirement Plan for Employees of Dixie Engine Co.*, 848 F.2d 1164, 1167 (11th Cir. 1988); *see also Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844, 104 S.Ct. 2778, 2782, 81

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[3] *Reich v. Valley Nat. Bank of Arizona*, 837 F.Supp. 1259 (S.D. N.Y. 1993); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983).

L.Ed.2d 694 (1984) ("[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.") *Bartling* 29 F.3d at 1072

The DOL's position is that mere reliance on experts *fails to discharge fiduciary duties.*

APPLICATION OF STATE SECURITIES LAWS SUCH AS CALIFORNIA CORPORATION CODE § 1800 IS CONSISTENT IN THE CIRCUITS

Without dissent and relegated to a footnote was the circuit court's dismissal of petitioners' contention that ERISA pre-empts state security laws (here, Cal. Corp. Code § 1800), citing *Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498 (9th Cir. 1993). Using a tortured analysis, the petitioners contend that this holding is in conflict with *Sommers Drug Stores v. Corrigan Enterprises, Inc.*, 793 F.2d 1456 (5th Cir. 1986) and *McCallum v. Rosen's Diversified, Inc.*, 41 F.3d 1239 (8th Cir. 1994). Neither case stands for the proposition cited by petitioners.

The pre-emption issue has been decided by the United States Supreme Court in *N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance*, __ U.S. __, 115 S.Ct. 1671 (1995). The State of New York had enacted provisions for surcharges on bills of patients whose insurance was obtained by employee health care plans governed by ERISA, and for surcharges on HMOs insofar as their membership fees were paid by an ERISA plan. The court held that these differing provisions for surcharges do not "relate to" employee benefit plans within the meaning of ERISA's pre-emption provision, 29 U.S.C. § 1144(a) (ERISA § 514(a)), and accordingly, are not pre-

empted. The court observed:

> . . . we have never assumed lightly that Congress has derogated state regulation, but instead have addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law. *N.Y. State Conference* 115 S.Ct. at 1676

The court reaffirmed that to read any law that indirectly relates to an ERISA plan as being pre-empted would effectively read the limiting language of § 514(a) out of the statute, a conclusion that would violate basic principles of statutory interpretation and could not be squared with prior decisions of the court.

California Corporations Code § 1800 provides that a minority shareholder in a closely held corporation (less than 35 shareholders) may seek involuntary dissolution of the corporation and obtain a court ordered liquidation of its assets if "it is reasonably necessary to protect the shareholders' interest." It is not disputed by the petitioners that this is a valuable property right of a minority shareholder in California, whether ESOP or not. When a minority shareholder petitions for liquidation under § 1800, California Corporations Code § 2000 provides that the holders of 50% or more of the voting power of the corporation may avoid the dissolution of the corporation by purchasing for cash the shares owned by the minority shareholders at fair value. Section 2000(a) defines fair value:

> The fair value shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation. *Id.*

Taking the premise that liquidation value cannot be the fair market value (an unsupportable premise), petitioners argue for pre-emption.

> ERISA § 514(b)(2)(A) specifically holds:
> - - - [N]othing in this title shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking or securities.

Petitioners cite *Ft. Halifax Packing Co. v. Coyne*, 482 U.S. 1, 107 S.Ct. 2211 (1987) as an example that Congress intended national standards for all fiduciaries. Petitioners fail to advise this court that the holding of *Ft. Halifax*, *supra*, is totally inapposite to that position. A Maine state statute required employers to provide a one time severance payment to employees in the event of a plant closing. Not wanting to pay those benefits, *Ft. Halifax* argued that any state law pertaining to a type of employee benefits listed in ERISA necessarily regulates an employee benefit plan, and therefore must be pre-empted. *Ft. Halifax* argued that ERISA foreclosed virtually all state legislation regarding employee benefits. Justice Brennan, writing for the majority of this court (in a section immediately following petitioners' quote, but omitted) stated:

> The purposes of ERISA's pre-emption provision make clear that the Maine statute in no way raises the types of concerns that prompted pre-emption. Congress intended pre-emption to afford employers the advantages of a uniform set of administrative procedures governed by a single set of regulations. This concern only arises, however, with respect to benefits whose provision by nature requires an ongoing

> administrative program to meet the employer's obligation. It is for this reason that Congress pre-empted state laws relating to *plans*, rather than simply to *benefits*. Only a plan embodies a set of administrative practices vulnerable to the burden that would be imposed by a patchwork scheme of regulation. *Ft. Halifax* 482 U.S. at 11-12

Rather than supporting petitioners' position, *McCallum v. Rosen's Diversified, supra*, held that there was *no* pre-emption of a state securities statute:

> We conclude that section 751 does not relate to the employee benefit plan within the meaning of ERISA and, accordingly, ERISA will not serve to preempt appellant's Section 751 claim. *McCallum*, 41 F.3d at 1242

Similarly, *Sommers Drug Stores v. Corrigan Enterprises, Inc.*, 793 F.2d 1456 (5th Cir. 1986) held that ERISA did not pre-empt a state law breach of fiduciary duty. The Fifth Circuit reasoned that the state common law fiduciary duties centered upon the relationship between the corporate director and the shareholder. ERISA fiduciary duties, governing the relationship between the plan or planned beneficiaries are parallel but independent. *Sommers* held that a state's corporation law *was not pre-empted and could be used to prevent looting of a plan by the controlling shareholder.*

The argument asserted by petitioners (but not addressed by the Ninth Circuit) that there can be no reference to state law in valuation of stock owned by an ESOP is speculation, devoid of legal foundation. The cited cases of *Sommers* and *McCallum*, as well as *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S.Ct. 1757

(1994) support the respondents and destroy the petitioners' assertion of conflict.

Had the fiduciaries conducted any independent investigation, they would have determined that pursuant to *Brown v. Allied Corrugated Box Co.*, 91 Cal.App.3d 477 (1979), discounts of the type used by AY to reduce the price that Shay would pay for the stock are inappropriate when the minority shareholder is being bought out by the controlling shareholder. Had the fiduciaries, AY, or its attorneys conducted an independent investigation, they would have also determined that the court in *Ronald v. 4-C's Electronic Packaging, Inc.* 168 Cal.App. 290 (1985), had rejected the minority discount when the minority shareholders invoke the protection of California Corporations Code §§ 1800 and 2000. They would have also found that under *Stumpf v. C.E. Stumpf & Sons, Inc.*, 47 Cal.App.3d 230 (1975), the corporation could be dissolved without grounds and without a showing of mismanagement when required to show fairness to the minority shareholders. See also *Charland v. County View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991).

NEITHER THE STANDARD OF REVIEW NOR THE VALUATION METHODS ARE PROPERLY BEFORE THE COURT

The monetary value of the stock is not an issue ripe for decision by this court. The Ninth Circuit determined that there was a breach of duty (A 7), that the so-called independent valuation of the stock was blindly accepted and never analyzed by the fiduciaries (A 10), and reversed and remanded the case for determination of damages to the district court (A 3). Having found as a matter of law that an improper standard was utilized by the trial court, it had

no occasion to determine whether or not the valuation was correct. That it viewed the result as suspicious based on the conduct of the fiduciaries and their controlling leash on AY is obvious.

Assuming that the questions raised by the Ninth Circuit concerning the AY evaluation are correct, the proper standard of review is set forth in *Long v. Flying Tiger Line, Inc.*, 994 F.2d 692, 694 (9th Cir. 1993) where the court held that it reviews the district court's "interpretation of ERISA, a federal statute, [as] a question of law subject to de novo review." (In accord, *Matter of McLinn* 739 F.2d 1395 (9th Cir. en banc 1984)). Cases cited by the petitioners on the standard of review do not stand for the proposition for which they are cited. *Citibank N.A. v. Wells Fargo Asia Ltd.*, 495 U.S. 660, 110 S.Ct. 2034 (1990) dealt with a pure factual determination, not an issue of law and fact. *Eyler v. C.I.R.*, *supra*, applied the only standard that a court can apply to a review of a tax court matter, i.e. whether or not the facts are clearly erroneous. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981) did not discuss the standard of review whatsoever. There was a hypothetical rumination as to what the district court might have done, but there was no holding on the standard of review. *Estate of O'Connell v. C.I.R.*, 640 F.2d 249 (9th Cir. 1981) is once again a review of a tax court decision, where the clearly erroneous standard is singularly applied.

Perhaps the most egregious mis-citation is *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996). Petitioners cite it for proof that the clearly erroneous standard is mandated. That court held at page 197:

> This appeal is taken from a final summary judgment predicated on stipulated facts and the district court's interpretation of a federal

statute, which we review *de novo*. *Id.*

Also in accord with de novo standard of review are *The Meadows v. Employers Health Ins.*, 47 F.3d 1006 (9th Cir. 1995) (reaffirming that de novo review is appropriate when the question is whether ERISA pre-empts state law), *Serrato v. John Hancock Life Ins. Co.*, 31 F.3d 882 (9th Cir. 1994) (confirming de novo review of the district court's interpretation and application of ERISA and determination that ERISA pre-empts certain state laws), and *St. Francis Regional Medical Center v. Blue Cross & Blue Shield of Kansas, Inc.*, 49 F.3d 1460 (10th Cir. 1995) (reaffirming de novo review of trial court's interpretation of ERISA).

By application of the law to the proper standard of review, the Ninth Circuit came to the correct conclusion, overturning the erroneous findings of the district court.

PETITIONERS' RELIANCE UPON THE *ESTATE OF BRIGHT* IS INAPPROPRIATE

Petitioners attempt to use *The Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. en banc, 1981) to argue that the Ninth Circuit overlooked the requirements of Revenue Ruling 59-60 and its impact on the valuation of the stock. Petitioners reliance on *The Estate of Bright* is misplaced, since the only issue addressed by the court was the value of the stock for estate tax purposes. In the instant case, the matter is irrelevant. As the en banc panel noted:

> The only issue facing the en banc court is whether the district court erred in entering the above-quoted pretrial order relating to the element of control. *Bright* 658 F.2d at 1000.

The pretrial order of the district court referred to provided,

in pertinent part:

> [N]o element of control can be attributed to the decedent in determining the value of the decedent's interest in the stock . . . for estate tax purposes. The parties are hereby ordered to proceed with preparation for trial and trial of this case on that basis. *Bright* 658 F.2d at 1000.

The portions of *Bright* relied upon by petitioners deal with the court's rejection of the government's arguments that what was transferred by the decedent was an "undivided one-half interest in the control block of 55% of the stock, and the second based on family attribution between the estate's stock interest and the stock interest held individually by Mr. Bright." (658 F.2d at 1000.) Thus, *Bright* does not stand for the proposition presented by petitioners.

Petitioners' motive in relying so heavily upon *Bright* is that, before the instant case, its 73% discount (658 F.2d 1008, fn.1) was the largest discount ever accepted by any court. (*See generally:* Appendix C to plaintiffs/appellants' Opening Brief filed in the circuit court.)

The futility of petitioners' arguments are easily dispelled by reference to the requirements of Revenue Ruling 59-60. While petitioners continuously recite the "willing buyer/willing seller test," Revenue Ruling 59-60 2.02 defines fair market value as " . . . the price at which the property would change hands between a willing buyer and a willing seller *when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. . . .* " (Emphasis added.) Fiduciaries who blindly accept the result of a valuation cannot be held to have reasonable knowledge of relevant

facts.

PAE is essentially a real estate holding company with net real estate assets of at least $78,000,000. Revenue Ruling 59-60, Section 5(b) states:

> The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type, the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. (G 11-G 12)

The application of Revenue Ruling 59-60 to the valuation of the real estate assets owned by PAE mandates that the fiduciaries not accept an 87% discount on those assets.

While petitioners argue that the buyer and seller are hypothetical and must be considered in a vacuum, Revenue Ruling 59-60, Section 4.02(g) compels:

> Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. *Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value.* (G 10)

Although *The Estate of Bright* court approved a 73% discount which petitioners so desperately seek in this case, Revenue Ruling 59-60 demonstrates the futility of their position and mandates return of this matter to the district court for a determination of damages.

CONCLUSION

Pursuant to United States Supreme Court Rule 10, petitioners' request for review on a Writ of Certiorari is meritless. Further, respondents fulfill their obligation under United States Supreme Court Rule 15 by pointing out the untimeliness of petitioners' arguments on methodology, valuation, or the ultimate fair market value of the stock transaction.

The conflicted fiduciaries absolutely breached all traditional notions of independence, fairness and rational financial reasoning. The Ninth Circuit was correct in its decision, both based on the law and the facts.

Respondents respectfully request that petitioners' request for review be promptly denied, and that the matter be remanded back to the district court for a

determination of damages that has been owed to this ESOP since 1988.

DATED: April 17, 1997

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